

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF ELECTRIC)
RATES OF KENTUCKY UTILITIES)
COMPANY)

CASE NO. 8624

O R D E R

On April 7, 1983, Kentucky Utilities Company ("K.U.") filed an application for rehearing of the Commission's Order entered March 18, 1983. Responses to K.U.'s application were filed by the Office of the Attorney General ("A.G.") on April 15, 1983, and Lexington-Fayette County Urban County Government and Willamette Industries on April 19, 1983. K.U. filed a reply to the A.G.'s response on April 21, 1983.

K.U.'s application presents 13 issues which it believes should be reconsidered in a rehearing. The first issue is an allegation that the Commission's Order lacks due process because K.U. was denied a fair and open hearing as to the issues and claims of its adversaries, who should be required to go on record with their recommendations and be subject to cross examination. The case of Mayfield Gas Coal v. PSC, Ky., 259 S.W.2d 8 (1953), is cited to support this argument. In the Mayfield case, a member of the Commission staff presented testimony but no opportunity for cross examination was afforded. The Court held that due process requires the opportunity to hear and examine witnesses

whose testimony is presented. K.U. had every opportunity to hear and examine those witnesses who presented testimony in this proceeding. None of the cases cited by K.U. requires the staff to present testimony.

K.U.'s characterization of the staff as adversarial is incorrect. Staff is an arm of the Commission; it is not an adversary party to a proceeding before the Commission. Subjecting the Commission staff to cross examination would be akin to cross examining the law clerks of a judge or the staff attorneys of an appellate court. Such a procedure would inhibit the free flow of ideas between staff members and Commissioners which is crucial to the functioning of this agency.

It is appropriate for the Commission to state its present perception of the role of the staff by referring to the following comments by Professor Davis:

The institutional decision often reaches a level which is higher than that attainable by the ablest of administrators who are cut off from their advisers. The administrative process builds on the principle that is used by a large medical clinic, which often can provide medical services superior to what any individual physician can provide, by bringing many kinds of specialists into an organization which is planned so as to provide a maximum of effectiveness to the aptitudes of each individual. The institutional mind has insights that are as profound as those of any individual and may be much more comprehensive, for the appropriate specialists collaborate, checking the judgment of each other, each drawing upon his own peculiar knowledge and skills.

Group work at its best may involve a good deal more than consultation by deciding officers with reviewers of records and with specialists. A system of

internal checks and balances may develop. Two minds are often much better than one, for the second may catch errors and rectify the faults of the first, and the interplay between the two may illuminate dark areas into which neither one alone can penetrate.

* * *

The role of an agency's staff is usually a vital part of the administrative process. It is a source of special strength of the administrative process, and it also introduces elements of special weakness. The strength springs from the superiority of group work--from internal checks and balances, from cooperation among specialists in various disciplines, from assignment of relatively menial tasks to low-paid personnel so as to utilize more economically the energies of high-paid personnel, and from capacity of the system to handle huge volumes of business and at the same time maintain a reasonable degree of uniformity of policy determinations. The weakness stems from the tendency toward anonymity of the advisers, from reliance on extrarecord advice, from frustration of parties' desire to confront those whose reactions are crucial in the decisionmaking, and from the failure to use opinion writing as a discipline for thinking out every facet of the decisionmaking. 1/

Cross examination of the staff could border on inquiry into the decision-making processes of the members of the Commission.

This is not required.

The Supreme Court of the United States long ago established the principle that the deliberative processes by which regulators reach their decision must be insulated from public scrutiny if the integrity of the administrative process is to be protected. In Chicago, Burlington & Quincy Ry. v. Union Pacific R.R., 204 U.S. 585, 593 (1907), Justice Holmes had this to say about cross examination of members of the state tax board by parties before it:

1/ K.C. Davis, Administrative Law Treatise, §17.1, at 227-79 (2d ed. 1980).

The members of the board were called, including the governor of the state, and submitted to an elaborate cross-examination with regard to the operation of their minds in valuing and taxing the roads. This was wholly improper. In this respect the case does not differ from that of a jury or an umpire, if we assume that the members of the board were not entitled to the possibly higher immunities of a judge. Jurymen cannot be called, even on a motion for a new trial in the same case, to testify to the motives and influences that led to their verdict. So, as to arbitrators. (Citations omitted.)

Indeed, in more recent opinions, the Supreme Court has stated that there is no difference between cross examining members of an administrative agency and a judge, as seen in United States v. Morgan, 313 U.S. 409, 422 (1941):

The proceeding before the Secretary 'has a quality resembling that of a judicial proceeding.' Such an examination of a judge would be destructive of judicial responsibility. We have explicitly held in this very litigation that 'it was not the function of the court to probe the mental processes of the Secretary.' Just as a judge cannot be subjected to such a scrutiny, so the integrity of the administrative process must be equally respected. (Citations omitted.)

Likewise the Supreme Court has rejected attempts to obtain the working papers of an administrative board on the ground that such a procedure would be equally disruptive of the agency work. This point was emphasized in United States ex rel. St. Louis Southwestern Ry. v. ICC, 264 U.S. 64, 78 (1924):

[T]he work of the Commission must go on, and cannot be stopped, as it would be if many of the railroads concerned undertook an examination of all its papers to see what they could find out.

Just as the courts have rejected attempts to obtain the papers of the members of an administrative body and cross examine

such members, so also has this protection been extended to the staff serving such commission or board members. The reasoning behind this salutary rule was well stated in T.S.C. Motor Freight Line, Inc. v. United States, 186 F. Supp. 777, 790 (S.D. Texas 1960), aff'd sub nom. Herrin Transportation Co. v. U.S., 366 U.S. 419 (1961):

Congress is aware of the tremendous volume of business which is the ultimate responsibility of the Commission, and hence the Commissioners.... Congress did not mean to leave this small group of Commissioners bereft of staff assistance in the assimilation of the great flood of formal cases requiring decision. The decision is still that of the Commissioners. Each bears full legal and personal accountability for that which bears his name or concurrence. The system requires a full public report of reasons and conclusions. With these safeguards Congress deemed the question of the identity and actions of staff assistants to be matters beyond question by the parties. (Emphasis supplied.)

K.U. further alleges that due process entitles it to know, and to have an opportunity to challenge, action contemplated and taken in the Order that was not raised as an issue by any intervenor. However, as noted in the A.G.'s response, K.U. has failed to disclose any action that was based on an issue which K.U. neither knew nor had an opportunity to challenge. In a subsequent section of its application K.U. requests a rehearing on the issue of coal inventory, based in part on its allegation that the Commission decided a matter which was not an issue in the case. K.U. claims that neither prehearing data requests nor staff questioning during the hearings disclosed that the Commission or staff was claiming that the level was too high and should be reduced.

KRS 278.190(3) places upon the utility the burden of proving that its proposed rates are just and reasonable. The purpose of the prehearing data requests and hearing cross examination was to determine whether K.U. had met its burden of proof. K.U. made a witness available at the hearing for questioning on coal inventory and fully discussed the issue in its post-hearing brief. K.U. has failed to substantiate its claim of a denial of due process.

Transmission Rental Expense

The second issue presented by K.U. is the Commission's disallowance of a \$1,019,215 increase in transmission line rental expense. K.U. alleges that it has additional evidence to offer regarding the method of expense allocation utilized by the Commission. In its Order, the Commission recognized that K.U. might have such additional evidence. Accordingly, a rehearing is granted on this issue.

Capitalization of Overhead Costs

The third issue raised by K.U. is that the Commission erred in requiring that overhead costs be capitalized without adding those costs to K.U.'s rate base. The Commission is of the opinion that the issue of capitalizing overheads was thoroughly addressed by all parties during the course of the original proceedings. K.U. failed to raise the issue of increasing capitalization to reflect the test year level of overhead costs which should have been capitalized. The A.G. supports K.U.'s position. The Commission will grant a rehearing to allow K.U. to provide

additional evidence that the \$1,685,130 should be added to the capital structure and that revenue requirements should be increased by \$383,937.

Antitrust Legal Expense

K.U. claims the Commission erred in disallowing \$216,887 of test year legal expenses associated with an antitrust suit. K.U. alleges that the proof is uncontradicted that the litigation has been maintained by its municipal wholesale customers and the Southeastern Power Administration and that K.U.'s other customers receive a benefit from its successful defense. The Commission is of the opinion that K.U. should be afforded the opportunity to present additional evidence (including case law and other authority) to support its claims that its Kentucky retail customers benefit from its defense and that there would be additional costs to these customers if its defense proves unsuccessful. Therefore, a rehearing will be granted.

Nonrecurring Environmental Expense

The fifth issue raised by K.U. is that the Commission erred in disallowing test year environmental expenses. K.U. argues that compliance with an increasing number of complex environmental regulations is a matter of "business as usual" for it and that the fact that this particular expense will not be recurring misses the point. The Commission finds that the replacement of one non-recurring expense with another may or may not occur. K.U. presented no quantifiable evidence of costs that would be

incurred prospectively in place of this particular expense. The Commission will not require K.U.'s customers to pay for an expense that will not be incurred in the future. The denial of this expense is consistent with the Commission's established rate-making principles. Therefore, the request for rehearing on this issue is denied.

Pro Forma Depreciation Expense

The sixth issue raised is the Commission's disallowance of depreciation expense on post test year additions to plant in service. In denying this adjustment the Commission adhered to its established rate-making practice of using the test year end rate base. This is consistent with the Commission's treatment of post test year additions which result in a mismatch of rate base and capital with revenues and expenses.

K.U. has made reference to the Commission's treatment of depreciation expense in Case No. 8648, Adjustment of Rates for Wholesale Electric Power to Member Cooperatives of East Kentucky Power Cooperative ("EKP"). Additional depreciation was allowed in that case primarily to reflect the addition of non-revenue producing pollution control facilities. EKP's sources of capital differ from those of K.U. and the extent to which EKP had included this plant in construction work in progress at the end of the test year did not require a post test year adjustment to capitalization.

The Commission's treatment of K.U.'s depreciation expense is consistent with that afforded all other investor-owned electric

utilities. Since K.U.'s application fails to present any arguments that were not previously presented and considered by the Commission, a rehearing is denied on this issue.

Deferred Taxes

K.U. claims that since uncontradicted proof supports its amortization of a \$1,526,685 deficiency in deferred taxes, the Commission's disallowance of this adjustment is improper. Contrary to K.U.'s allegation, its proof was directly contradicted by the testimony of the A.G.'s witness, Mr. Hugh Larkin. Although K.U. argues that its adjustment is in accordance with Order No. 144 of the Federal Energy Regulatory Commission ("FERC"), it has failed to offer any evidence to show the relevance of the FERC Order to this Commission's jurisdiction of K.U.'s retail operations. Further, K.U. was unable to determine the source of the deficiency. The deficiency is probably a result of K.U.'s voluntary or inadvertent decision in prior years to follow flow-through tax accounting. Any future collection of such a deficiency would constitute retroactive rate-making. No new arguments have been presented to support a rehearing on this issue, and it is therefore denied.

Capital Structure

The eighth issue raised by K.U. is the Commission's treatment of total capitalization. K.U. argues that the test year capitalization should be updated to reflect permanent additions after the test year, including 1.5 million shares of common

equity issued in January, 1983, and a \$25 million dollar preferred stock issue in August, 1982. K.U. maintains that, without supporting findings or comment, the Commission determined not to include that new capital in K.U.'s rate base. The Commission asked for updates for K.U.'s financings, beyond the test year, to determine how close K.U. was to achieving its proposed target capital ratios.

The Commission did update K.U.'s capital ratios to reflect financings that occurred subsequent to the test year. These updated ratios were applied to test year capitalization as requested by K.U. in its prefiled testimony, hearing testimony and post-hearing brief. K.U. witness Mr. John Newton stated that:

...capitalization has been adjusted to reflect sound (i.e., 'target') equity and debt ratios. Note that we are not proposing to increase test year total capital but only to increase the ratio of equity to debt. (Newton Prefiled Testimony, page 3.)

K.U. argued in its brief that:

The Company is not proposing to increase test year capital but only to increase the ratio of equity to debt. Increased common and preferred would be offset by a corresponding reduction in long term debt and the elimination entirely of short term debt. (K.U. Brief, page 17.)

The updated exhibits were submitted by K.U. in compliance with a Commission Order. However, at the hearing K.U. stated:

Now, we do not submit those Exhibits to ask this Commission to base its determination of revenue requirements on those Exhibits. We submit them only for illustrative purposes to show what happens with reference

to the capitalization that we were requested to update.
(T.E. Vol. I, page 42.)

Clearly, until the application for rehearing, K.U. had not asked this Commission to update total capitalization to reflect permanent additions beyond the test year. Rather, K.U. requested that its capital ratios be adjusted to proposed target ratios.

Although the Commission did allow K.U. to update its amount of capitalization in a previous rate case, there was no opposition to the adjustment in that case and in retrospect it was erroneous and a violation of the test year concept of rate-making. In this case, the A.G. vigorously opposed any adjustments to the test year end capitalization. A rehearing on this issue is denied.

Coal Inventory

K.U. claims that the Commission's reduction of coal inventory by 387,431 tons was a decision on a matter not in issue in the case and contrary to the proof of an acceptable level of inventory and prudent management of inventory. The claim that coal inventory was not an issue in this case is fully discussed and rejected in a previous section of this Order. K.U. alleges that the constraints of its long term coal supply contracts prevent any reduction in the level of coal inventory. The Commission will grant a rehearing to allow K.U. to present additional evidence on an acceptable level of coal inventory.

Hancock County Expenditures

The tenth issue raised by K.U. is the Commission's exclusion from construction work in progress ("CWIP") of Hancock County generating station ("Hancock County") engineering and environmental expenditures. K.U. alleges that the exclusion was based on hindsight and is contrary to the evidence.

In K.U.'s last rate case the Commission gave notice that these expenditures would be an issue in this case. K.U. argues that since Hancock County expenditures were not excluded in its last rate case, res judicata now requires a showing of changed circumstances. This argument was squarely rejected by the Supreme Court's holding that, "a rate order is not res judicata." Tagg Bros. v. Moorhead, 280 U.S. 420, 445 (1930). See also Legislative Utility Consumers' Council v. P.S.C. of N.H., 402 A.2d 626 (N.H. 1979).

The evidence in this case established K.U.'s poor forecasting techniques, failure to document adjustments to forecasts and inadequate consideration of alternatives to construction of Hancock County. Based on these findings the Commission determined that the expenditures were not prudent for inclusion in CWIP. K.U. has failed to offer any evidence to show why its present customers should pay for a generating station that will not be in service for at least 10 years. A rehearing on this issue is denied.

Rate of Return

K.U. protested the Commission's reduction of return on equity and overall cost of capital below those granted in its previous rate case. K.U. states that the Commission's action was arbitrary, unreasonable and had no support in the record. In determining a fair rate of return the Commission considers the evidence presented and current economic conditions. See Citizens Tel. Co. v. PSC of Ky., Ky., 247 S.W.2d 510 (1952). The Commission does not consider returns granted in prior rate cases to be deciding factors in current cases. In Case No. 7804, General Adjustment of Electric Rates of Kentucky Utilities Company, the Commission allowed K.U. to earn 13.9 percent on common equity. In Case No. 8177, General Adjustment of Electric Rates of Kentucky Utilities Company, K.U. was allowed to earn 16 percent on common equity, an increase of 2.1 percentage points. Part of that increase was attributable to economic conditions including double digit inflation. Inflation has moderated substantially since the Commission decided Case No. 8177. K.U. witness Dr. Charles Haywood agreed that the lower rate of inflation would reduce the gap between the earned return and allowed return. (T.E., Vol. II, page 127.) A lower return than was granted in Case No. 8177 is reasonable based on current economic conditions. The 15.25 percent return on equity granted in this case is within the range proposed by the A.G. Rehearing on the issue of rate of return is therefore denied.

Price Elasticity

The twelfth issue is the Commission's denial of K.U.'s price elasticity adjustment. K.U. contends its adjustment is conservative because the "misconceptions" of the model were explained and handled in a manner which actually reduced the adjustment factor. The Commission is of the opinion that the issue is not whether the adjustment is conservative but whether the underlying statistical model provides sufficiently accurate information to permit a known and measurable adjustment to revenue. K.U. has failed to provide the statistical tests necessary for the Commission to make that decision.

K.U. further alleges that denial of this adjustment is inconsistent with the Commission's Order in its last rate case, Case No. 8177, and is contrary to rate-making principles. In Case No. 8177 the Commission explicitly rejected the price elasticity adjustment because it resulted in shifting risks from K.U. shareholders to K.U. customers without an appropriate reduction in allowed return on equity. The Commission is of the opinion that K.U.'s authorized return on equity provides adequate compensation to its shareholders for the business risks incurred in supplying electric service. Therefore, a rehearing on this issue is denied.

Consultant's Study

The thirteenth issue for rehearing relates to the matter of a consultant's study. The Commission's Order of March 18, 1983,

identifies several issues to be addressed in this study. These issues are clearly interrelated with the Commission's statutory authority to fix rates and service standards. Further KRS 278.250 authorizes the Commission to conduct such an investigation.

Since the benefits will inure to K.U. ratepayers, the cost to K.U. for this study will be fully recoverable through rates from its consumers. The Commission is of the opinion that the cost of the study will have a de minimus effect on K.U. operations. If K.U. is awarded additional revenues upon rehearing, the cost of the study will be included. Otherwise, it will be allowed as a rate-making expense in K.U.'s next rate case.

The Commission intends to incorporate the study in this case into Case No. 8666, State Wide Planning for the Efficient Provision of Electric Generation and Transmission Facilities. While the Commission was considering how to proceed in Case No. 8666, this case and two other major electric rate cases, Case No. 8616, General Adjustment In Electric and Gas Rates of the Louisville Gas and Electric Company, and Case No. 8648, Adjustment of Rates for Wholesale Electric Power to Member Cooperatives of East Kentucky Power Cooperative Inc., were pending before the Commission. In all three cases there was considerable discussion of the quality of the load forecasts and system planning operations. It was determined that there would be economies to be gained by using the consultant in Case No. 8666 in this case to do additional

analysis of the financial impacts of changes in construction schedules and implementation of conservation programs as an alternative to construction, and in Case Nos. 8616 and No. 8648. Thus, this study and the studies ordered in the other two cases are to be incorporated into the study in Case No. 8666.

In an effort to afford K.U. an opportunity to present its concerns regarding the consultant's study, the Commission will, accordingly, grant rehearing on this issue. However, before the Commission conducts the rehearing on this issue, there will be a conference among representatives of K.U., Louisville Gas and Electric, East Kentucky Power and all other parties in Case No. 8666. Before this conference, the Commission will issue an Order explaining the procedures for the consultant's study. The Commission is confident that all of K.U.'s concerns will be answered at the conference. However, K.U. will have 10 days after the conference to reassert any complaints it may still have. If this is done, the Commission will then proceed to hear additional evidence on this issue.

Summary

The Commission, having considered K.U.'s application for rehearing, the responses of the A.G., Lexington-Fayette Urban County Government and Willamette Industries, K.U.'s reply and the evidence of record, is of the opinion and finds that:

1. A rehearing should be granted on the issues of transmission line rental expense, capitalization of overheads, anti-trust legal expenses, coal inventory and the consultant's study.

2. A rehearing should be denied on the issues of denial of due process, nonrecurring environmental expense, pro forma depreciation expense, deferred taxes, capital structure, Hancock County expenditures, rate of return and price elasticity.

IT IS THEREFORE ORDERED that a rehearing be and it hereby is granted on those issues enumerated in Finding No. 1, and a rehearing be and it hereby is denied on those issues enumerated in Finding No. 2.

IT IS FURTHER ORDERED that a rehearing be and it hereby is scheduled on May 19, 1983, at 9:00 A.M., E.D.T., in the Commission's offices at Frankfort, Kentucky, and that a conference regarding the consultant's study be and it hereby is scheduled on May 18, 1983, at 10:00 A.M., E.D.T., in the Commission's offices at Frankfort, Kentucky.

IT IS FURTHER ORDERED that K.U. shall file no later than May 11, 1983, with the Commission and all parties of record, its prepared testimony on those issues scheduled for rehearing on May 19, 1983.

Done at Frankfort, Kentucky, this 28th day of April, 1983.

PUBLIC SERVICE COMMISSION

See Opinion Dissenting in Part
Chairman

Kathleen Baudale
Vice Chairman

Don Canizer
Commissioner

ATTEST:

Secretary

OPINION OF CHAIRMAN LAURA L. MURRELL

DISSENTING IN PART

I join in the majority opinion on all issues except the antitrust legal fees.

I would not grant a rehearing on the issue of antitrust legal fees. The issue is one of allocation of costs between intrastate (Kentucky jurisdictional or retail) expenses and interstate (FERC jurisdictional or wholesale) expenses. Expenses that can be directly assigned should be directly assigned. Only costs that cannot be directly assigned should be allocated on a percentage factor.

KU allocated most of its legal fees on a percentage factor including the antitrust actions fees, thereby requiring Kentucky intrastate customers to bear over 90 per cent of them. KU does not, and could not, deny that these fees related to interstate operations. Rather KU argues that there is some incidental benefit to Kentucky ratepayers and that they should, therefore, bear the bulk of these expenses.

By granting rehearing, the majority has indicated that the Commission will consider whether an expense directly assignable to interstate jurisdictional expenses indirectly benefits intrastate customers, and if they so find, that they will consider allowing it as an expense to be borne by intrastate customers. The many issues that are implicit in such an undertaking are mindboggling. First, there is

the question of the indirect benefit. KU argues that their opponents in the case seek an unfair cost benefit. Undoubtedly, their opponents feel differently. However, the Commission will only hear from one party to the litigation.

There are also other potential issues on the indirect benefit question. One that comes to mind is that if the litigation was to avoid the loss of load and this loss would have lowered past growth expectations, then perhaps the loss of load would have benefited retail customers by avoiding some of the expensive new construction, so that they may have received an indirect detriment, rather than the company's claimed indirect benefit.

In addition, there are the questions of the reasonableness and prudence of the expenses, which is something that this commission, being totally removed from the litigation, is in no position to pass on. I am not prejudging any of these issues, but am simply pointing out how complex they are. The Commission does not have to enter this thicket, and should decline to do so.


Laura L. Murrell
Chairman